

2. Planning the public finances

This chapter of the Green Budget discusses the planning of the public finances in the context of the fiscal rules that the government set for itself in 1998. Section 2.1 explains the rules and how compliance with them is assessed and looks at the errors made in the past when forecasting the public finances. It then examines whether getting the private sector to finance public investment can circumvent the rules. It concludes by comparing the current rules with the Growth and Stability Pact that would apply if Britain joined the Euro. Section 2.2 examines current issues that arise in planning and forecasting government revenues. It focuses on the effect of movements in the economic cycle and asset prices – with particular reference to stamp duty and corporation tax. Section 2.3 turns to current issues in forecasting and planning government spending. It focuses on public investment, public sector pay and the safety margin the government provides itself for unexpected spending demands.

2.1 The Chancellor's fiscal rules

In July 1998, the Chancellor outlined two fiscal rules that would constrain his tax and spending decisions. The stated rationale was to provide a credible framework within which the government could operate, to ensure the sustainability and fairness of the public finances.

- The **golden rule** states that the government will only borrow to fund investment and not current expenditures. This aims to ensure that future generations will only be repaying debt the accumulation of which benefits them through the stock of capital it financed.
- The **sustainable investment rule** states that public sector debt should remain at a 'stable and prudent' level, interpreted by the Chancellor as no more than 40% of national income. By constraining the total level of debt allowable, the long-term sustainability of the public finances is ensured.¹

These rules have to be met over the ups and downs of the economic cycle, rather than each and every year. When activity in the economy runs below the trend level thought consistent with stable inflation, weaker profits and higher unemployment mean that tax receipts are lower and government spending higher than can be sustained over the long term. The resulting injection of spending power into the economy in itself helps take activity back up to a sustainable level. Conversely, when activity is above trend, temporarily buoyant tax receipts and lower social security costs take spending power out of the economy and help cool it down. Applying the fiscal rules over the cycle rather than in every year allows these 'automatic stabilisers' to operate

¹ For a more in-depth discussion of the sustainability of the public finances, see HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/assoc_docs/prebud_pbr02_adsustain.cfm).

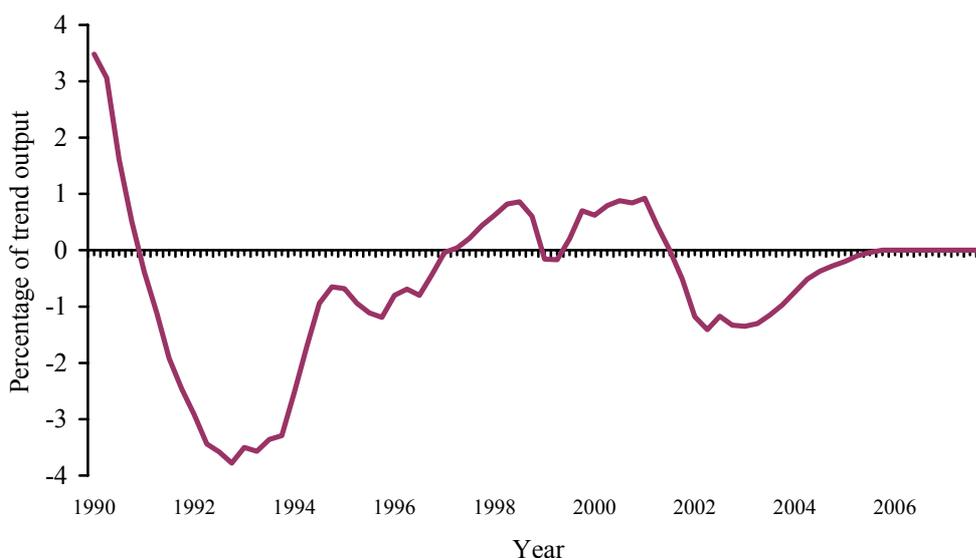
unimpeded.² The sustainability of the public finances is ensured since extra borrowing undertaken because the economy is below trend has to be repaid when it moves above trend.³

Assessing whether the golden rule is met

The golden rule stipulates that the government's borrowing should not exceed its spending on investment over the economic cycle. This means that tax revenue has to be sufficient, on average, to pay for the government's current spending (including depreciation). In other words, the 'current budget' – the surplus of receipts over current spending – has to be in balance or in surplus on average over the cycle.

Whether the golden rule has been met can only be judged definitively in retrospect, by examining the behaviour of the current budget over a full economic cycle. But it is hard to judge precisely where the economy is in the cycle at any given time. To do so, it is necessary to estimate the 'output gap' – a measure of where national income stands relative to the trend level assumed consistent with stable inflation.

Figure 2.1. HM Treasury estimates of the output gap



Note: Actual output less trend output as a percentage of trend output (non-oil basis).
Source: Chart A4 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002
(www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

The Treasury's estimates of the output gap from 1990 to 2008 are shown in Figure 2.1. The current cycle is assumed to have begun when output moved

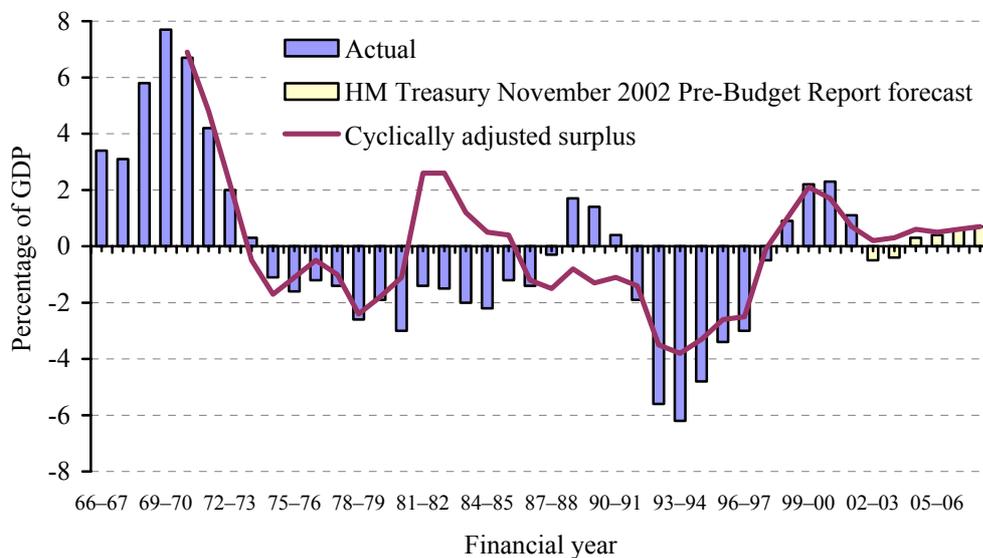
² The automatic stabilisers operate in the right direction, but the strength with which they do so is a function of the precise structure of the tax and benefits system and may not be optimal from the perspective of macroeconomic management.

³ A more detailed discussion of the government's fiscal rules can be found in C. Emmerson and C. Frayne, *The Government's Fiscal Rules*, Briefing Note no. 16, IFS, London, 2001 (www.ifs.org.uk/public/bn16.pdf).

above trend in 1999–2000 following a mini-cycle between quarter 1 of 1997 and mid-1999. Output then fell below trend again in 2001–02. Stronger growth is forecast to close the negative output gap by 2005–06, bringing the current cycle to an end.⁴

Figure 2.2 shows the surplus on current budget from 1966–67 to 2007–08, according to HM Treasury forecasts. Since the introduction of the golden rule, the current budget has been in surplus every year. This is in contrast to most of the years from 1973–74 until 1997–98, when current budget deficits occurred in all but the three years from April 1988 to March 1991. Over the cycle running from 1986 to 1997, the golden rule was far from met. Current budget deficits averaging over 4% of national income between 1991–92 and 1996–97 far outweighed the modest surpluses in the previous years.

Figure 2.2. Current budget surplus as a percentage of national income



Note: Measures exclude the windfall tax and associated spending.

Source: HM Treasury, *Public Finances Databank, January 2003*, London, 2003 (www.hm-treasury.gov.uk/media/4EC32/jan03web.xls).

But how are we to judge whether the current fiscal position is consistent with the golden rule, when we are in the midst of an uncompleted cycle? The November 2002 Pre-Budget Report (PBR) measures progress ‘by the average surplus on the current budget since 1999–2000, which on the government’s provisional judgement is the start of the current cycle’.⁵ Over the first three years of the cycle, the current budget averaged surpluses of 1.7% of national income a year. The Treasury predicts deficits of 0.5% this year and 0.4% in 2003–04, reducing the average over the cycle to date to 0.8% next year. The

⁴ Whether the mini-cycle between quarter 1 1997 and mid-1999 survives future revisions must remain somewhat in doubt, as output fell only fractionally below trend even at its weakest point. As the Treasury concedes, it may turn out that the current cycle began in 1997 and that the initial upswing was longer than current estimates suggest.

⁵ Paragraph 2.51 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

average since 1999–2000 is then expected to stabilise at 0.7% until the cycle ends.

This implies that the golden rule will be overachieved comfortably during the current cycle, even if the upswing is weaker than expected and the negative output gap takes a year or two longer to close. In cash terms, the Chancellor said in November that he expected to end the current cycle with a cumulative current budget surplus of £46 billion.⁶ This implies he could run cumulative current deficits of nearly £50 billion between now and the end of the cycle in 2005–06 without breaking the golden rule, rather than the £2.7 billion he currently projects.

But assessing compliance with the golden rule in this way can be unhelpfully backward-looking. Should the government really determine its fiscal room for manoeuvre by asking what deficits it can ‘afford’, given the size of the surpluses it has accumulated in the recent past? And what happens when the current cycle ends? Does the Treasury start again with a blank sheet of paper or does it argue that the deficits accumulated in the second half of the current cycle have to be offset by surpluses in the first half of the next?

Economic cycles are an endlessly repeating process and any point in time could, in principle, be taken as the start of a new cycle or the end of an old one. In reaching their Budget judgements, chancellors confront the legacy of past fiscal policy decisions and external shocks in the form of the public debt and its servicing costs. But provided the debt is not in itself on an unsustainable path (for example, as long as the debt-to-GDP ratio is stable over time, which is a requirement of the sustainable investment rule), it is not clear that the current balances recorded in the past should dictate the current balances permitted in the future. More relevant is whether the current budget is on course to be in balance or surplus on average looking forward – or whether tax increases and/or spending cuts are needed to ensure that it is.

The International Monetary Fund made a similar point in the concluding statement of its Article IV review of the UK economy in December: ‘It would be useful to assess whether the rules could be designed, or calibrated, so as to reduce their dependence on past over-performance, avoiding the risk that margins accumulated in the past allow excessive leeway in the future’.⁷ Symmetrically, it could have added that the rules should not mean that past deficits necessarily constrain the government to run an undesirably tight fiscal policy unless there is a risk of missing the debt-to-GDP target.

Whether fiscal policy is consistent with the golden rule looking forward is best assessed by focusing on estimates of the current budget balance that are adjusted (albeit imperfectly) for the impact of the economic cycle. The Treasury estimates that a 1% fall in national income increases public sector net borrowing (the current budget balance plus net investment) by 0.5% of

⁶ Chancellor of the Exchequer’s Pre-Budget Report Statement, 27 November 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_speech.cfm).

⁷ International Monetary Fund, ‘United Kingdom – 2002 Article IV Consultation Concluding Statement’, 9 December 2002 (www.imf.org/external/np/ms/2002/120902a.htm).

national income after one year and 0.2% after two years.⁸ So, given an estimate of the output gap, the Treasury can estimate what the underlying budget position would be if national income were at its trend level.

The cyclically adjusted current balance is also shown in Figure 2.2. It suggests that the current budget moved into surplus in the late 1980s only because of the extent to which the economy was operating above trend, which inflated tax revenues and cut social security costs. Similarly, it suggests that the big rise in the deficit in the early 1990s reflected both the impact of the recession and a weaker underlying fiscal position. Over the present economic cycle, the actual current balance and the cyclically adjusted current balance are projected to have moved, and to continue to move, pretty closely in line. This reflects lower volatility in national income, and therefore smaller output gaps.

The Treasury points to its forecast of an average current budget surplus of 0.7% of national income over this cycle as evidence of adequate caution in the setting of the public finances. The same could be said of its projections for the cyclically adjusted current budget, which is still just in surplus this year and next and which rises to 0.7% of national income by 2007–08. Projections of cyclically adjusted surpluses in future years could be interpreted as a reasonable indication that current policy is consistent with the golden rule, whatever the pattern of deficits or surpluses in the past.

This, of course, requires that those projections are realistic and that they contain an appropriate margin for error, given the uncertainties inherent in determining the size of the output gap and in distinguishing between cyclical and underlying movements in the public finances. In the Treasury's view, the golden rule will still be met even if the trend level of output turns out to be 1% lower than currently projected and if past surpluses therefore owed more to strong economic activity than to the underlying health of the public finances. The average current balance since the start of the cycle would remain positive throughout. Less reassuringly, the cyclically adjusted current balance would be consistently in deficit and only move back to balance by 2007–08.

Whether 0.7% of national income is an adequate cushion is a matter of judgement. It would not have been large enough to avoid missing the golden rule given some errors in estimating trend output in the past. But the reduced volatility of national income in the latest cycle suggests such errors are perhaps unlikely to be as large as they were in the late 1980s and early 1990s.

Let us assume, for the sake of argument, that trend output has been estimated correctly. Just as important a question in judging whether policy is now consistent with the golden rule is whether it is realistic to expect the cyclically adjusted current balance to rise to 0.7% over the next few years, as forecast in the PBR, without further tax increases or cuts in spending plans. (If this level were achieved and then maintained, the government would have the same level of caution built into its projections looking forward as it has signalled it was looking for in the past.) This prediction may be unduly reliant on

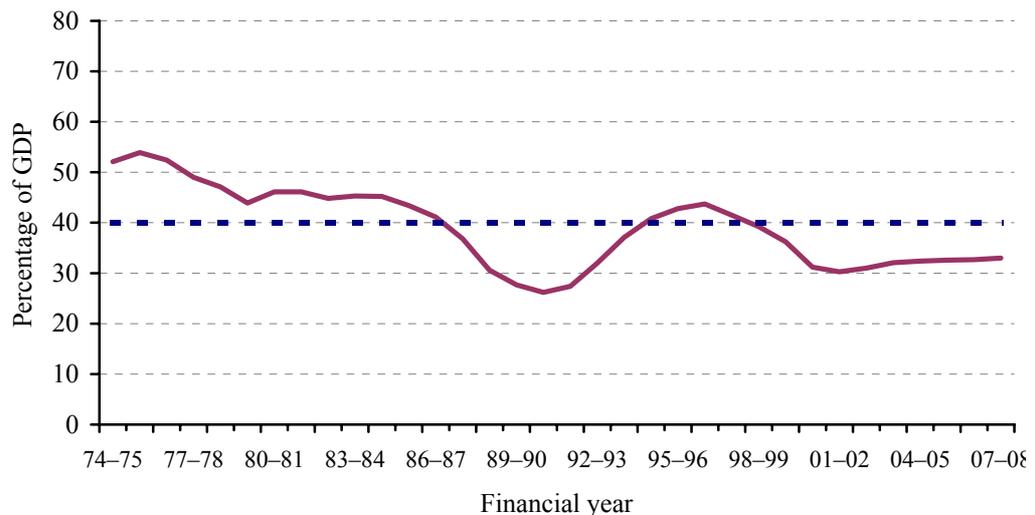
⁸ Paragraph B17 on page 185 of HM Treasury, *Pre-Budget Report: 2002*, Cm 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

ambitious forecasts – for example, for corporation tax receipts and movements in equity and housing markets, which are discussed in Section 2.2.

Assessing whether the sustainable investment rule is met

While the golden rule imposes a binding constraint on the government, this is not currently true of the sustainable investment rule. Figure 2.3 shows public sector net debt as a share of national income from 1974–75 to 2007–08. This has declined steadily from 43.7% of national income in March 1997, just before Labour took office, to 30.4% of national income in March 2002. Net debt is set to rise over the next six years, to reach 33.0% of national income in March 2008 according to Treasury plans for receipts and spending. Assuming that the golden rule is met, the government would need to spend an additional 7.0% of national income on public sector net investment to breach the sustainable investment rule. Given the difficulty that the government is having in increasing public sector net investment spending from an historical low of 0.5% of national income in 1999–2000 to 2.0%, such an increase seems highly unlikely.

Figure 2.3. Public sector net debt as a percentage of national income



Source: HM Treasury, *Public Finances Databank, January 2003*, London, 2003 (www.hm-treasury.gov.uk/media/4EC32/jan03web.xls).

Errors made in the past in predicting budget balances

In the 2002 PBR last November, the Treasury revised down the estimates of the current budget balance for this year and next that it published in the Budget last April. For the current financial year, it now forecasts a current deficit of 0.5% of national income, rather than a surplus of 0.3%, and for 2003–04, it forecasts a 0.4% deficit, rather than a 0.6% surplus. Both revisions are almost entirely due to lower-than-expected revenues. These forecasts are still consistent with cyclically adjusted surpluses in each year, but of only 0.2% and 0.3% of national income respectively. It would take only a small

forecasting error to see a cyclically adjusted deficit in one or both years. If such a deficit were maintained indefinitely, the golden rule would be missed.

Table 2.1 shows the Treasury's average error in forecasting public sector net borrowing (PSNB) – the current balance plus net investment – one, two, three and four years ahead between 1985–86 and 1997–98. It shows that even one year ahead, the average absolute error is £12.5 billion in today's prices. Even when the effect of misforecasting national income has been stripped out, there is still an average error of £10.4 billion. Underestimating borrowing by even half that magnitude for 2003–04 would lead to a cyclically adjusted deficit on current budget.⁹

Table 2.1. Average errors in forecasting public sector net borrowing, as a percentage of national income and in £ billion

Time period	Average error (% GDP)	Average error (£bn)	Average error, correct GDP (% GDP)	Average error, correct GDP (£bn)
One year ahead	1.2	12.5	1.0	10.4
Two years ahead	2.0	20.9	1.4	14.6
Three years ahead	3.0	31.3	2.0	20.9
Four years ahead	4.1	42.8	2.4	25.1

Notes: Figures in £ billion are calculated assuming HM Treasury GDP forecast for 2002–03 of £1,044 billion. Average error corresponds to the average absolute error over the period 1985–86 to 1997–98.

Source: Table B13 of HM Treasury, *Pre-Budget Report, November 1998*, Cm. 4076 (<http://archive.treasury.gov.uk/pub/html/prebudgetNov98/index.html>).

For the last two fiscal years, 2000–01 and 2001–02, the error in forecasting PSNB has been slightly lower, averaging 0.9% of national income. The End-of-Year Fiscal Report, published by HM Treasury alongside the November 2002 Pre-Budget Report, shows the errors made in forecasting borrowing one year ahead from 1989–90 to 2001–02. Over these years, the average error was 1.1% – slightly lower than the 1.2% presented in Table 2.1. Not surprisingly, borrowing tends to be underestimated when economic activity is weak.

The Private Finance Initiative and the interpretation of the fiscal rules

The fiscal rules constrain policy by requiring that public sector deficits and debt do not exceed particular levels over the economic cycle. Yet the definition of public sector net debt used does not measure the full cost of activities carried out on behalf of the public sector. This raises the possibility that the government could circumvent the fiscal rules by financing spending through liabilities that are not covered by the sustainable investment rule. This is possible under the Private Finance Initiative (PFI).

If a public investment project is paid for by conventional deficit financing, then the cost will appear immediately as public sector investment, and add to both public sector net borrowing and public sector net debt. In future years,

⁹ If the error were in public sector net investment, then this would not lead to a change in the current budget surplus.

the depreciation of the asset purchased, and the additional debt interest repayments, will score as current expenditure and reduce the size of any current budget surplus.

Alternatively, the government might use the private sector to finance and deliver the project. In this scenario, the cost of the capital spending would initially be paid for by the PFI contractor rather than scoring against public sector net borrowing. This would reduce public sector net borrowing and net debt compared with what they would have been under the conventional finance route. Initially, this would make the sustainable investment rule easier to meet.

Use of the PFI would also reduce depreciation costs, as the public sector capital stock is lower. The reduction in public sector net debt would also reduce future debt interest payments. But the annual stream of payments to the PFI contractor would score as current expenditure. If a private contractor were able to deliver a public sector investment project with efficiency gains that precisely offset their higher borrowing costs, then the project would cost exactly the same as under conventional finance. Hence it would not make the golden rule easier or harder to meet.¹⁰ The only economic rationale for using the PFI is that it is hoped it will offer better value for money. Despite the fact that the private sector faces higher borrowing costs, these are expected to be offset by its greater operating efficiency.¹¹ If this holds, the private contractor can provide a given standard of public service at a lower cost, which will, all other things remaining equal, lead to lower levels of public borrowing.

Table 2.2. Forecast capital spending by the public sector under both conventional finance and the Private Finance Initiative

	2002–03	2003–04	2004–05	2005–06
Public sector net investment (£bn)	14.3	19.6	21.9	24.1
Depreciation (£bn)	14.1	14.7	15.4	16.2
Asset sales (£bn)	3.8	3.8	3.8	3.8
Public sector gross investment (£bn)	32.2	38.1	41.1	44.1
Capital spending by the private sector (£bn)	3.7	3.3	2.5	2.5
Total publicly sponsored gross investment (£bn)	35.9	41.4	43.6	46.6
PFI investment as a % of total publicly sponsored gross investment	10.3%	8.0%	5.7%	5.4%

Notes: Figures on capital spending by the private sector correspond to signed deals only. Figure for 2005–06 is an estimate.

Source: Table 2.1 on page 10 of HM Treasury, *Spending Review 2002: Departmental Investment Strategies: A Summary*, Cm. 5674, Stationery Office, London, 2002 (www.hm-treasury.gov.uk/media/343A6/dis_whitepaper02.pdf).

Most publicly sponsored investment is still conducted through conventional means rather than through the PFI. In 2002–03, total publicly sponsored

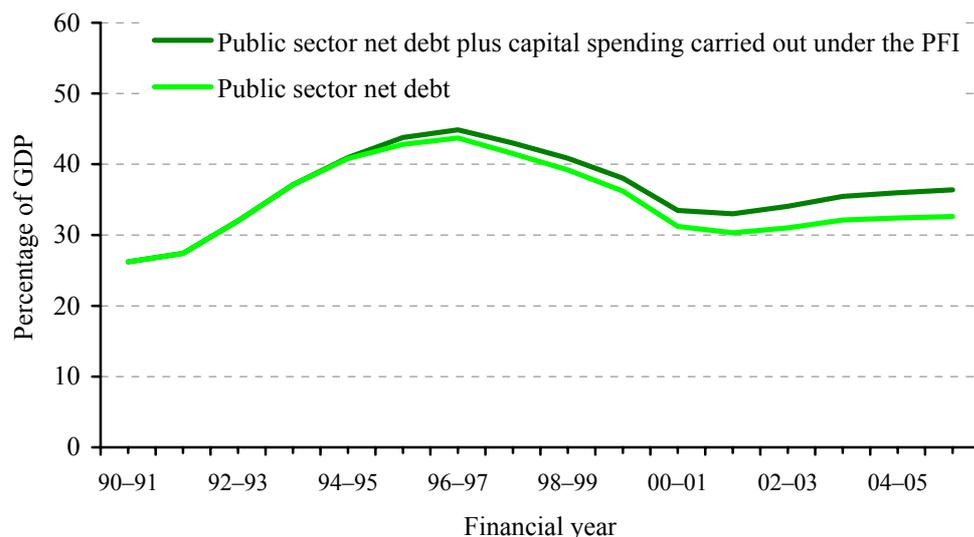
¹⁰ Assuming that payments are structured so that the annual payments to the private contractor correspond to the flow of services received.

¹¹ For a discussion of issues arising from private sector involvement in the delivery of public services, see chapter 3 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2002*, Commentary no. 87, Institute for Fiscal Studies, London, 2002 (www.ifs.org.uk/gb2002/chap3.pdf).

investment is expected by the Treasury to be £35.9 billion, of which just £3.7 billion, or 10.3%, will be financed by the private sector. Table 2.2 shows the share of public investment financed through the PFI declining. This is because the figures are based on deals that have been signed so far. Whether the share actually declines will depend on how many new PFI contracts are agreed. If current policy continues, we can expect to see a steady increase in the number of PFI contracts signed, leading to higher forecasts for government spending on the PFI.

On the basis of deals signed so far, public sector net debt at the end of March 2006 would be 3.8% of national income higher if all the capital spending from PFI deals signed so far been carried out using conventional finance.¹² This is shown in Figure 2.4. Should further PFI deals be signed, then net debt would be higher still. But it would remain comfortably below the government's 40% ceiling unless there were an unfeasibly large increase in investment spending (either financed conventionally or through the PFI) or unless the golden rule were also breached, in which case some of the additional borrowing would represent current rather than investment spending.

Figure 2.4. Public sector net debt as a percentage of national income



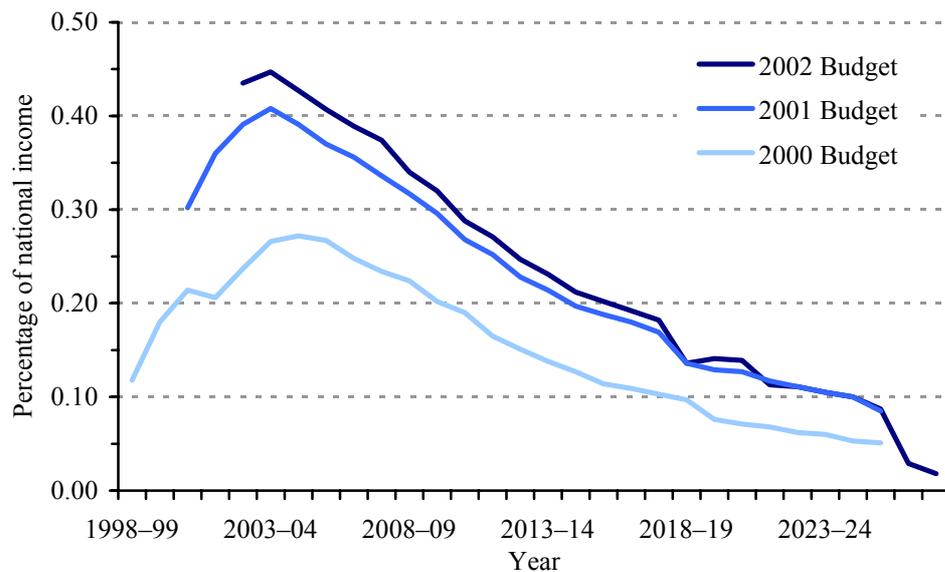
Source: HM Treasury, *Public Finances Databank, January 2003*, London, 2003 (www.hm-treasury.gov.uk/media/4EC32/jan03web.xls). Capital spending carried out under the PFI from T. Clark, M. Elsby and S. Love, 'Trends in public investment', *Fiscal Studies*, 2002, vol. 23, pp. 305-42.

So far, we have focused on what would have happened to the public debt had conventional finance been used to deliver all of the public sector investment projects that have been financed through PFI deals. An alternative approach is to look at the stream of payments that the government is committed to paying PFI providers in return for the services that they are providing.

¹² This assumes that the public sector could have carried out the investment spending at the same cost as the private provider.

The expected payments over the next 25 years from PFI contracts that have already been agreed are shown in Figure 2.5. It shows that if no further contracts are agreed, payments should rise to 0.45% of national income in 2003–04 before falling to less than 0.1% of national income in the mid-2020s. Again, as with the figures on capital spending by the private sector, this decline is unlikely to materialise because new contracts should be signed. We can therefore expect upward revisions to the projected future flow of payments under the PFI as we have seen in recent Budgets, as is shown in Figure 2.5.

Figure 2.5. Estimated future payments under Private Finance Initiative contracts as a percentage of national income



Sources: Table C15 on page 208 of HM Treasury, *Financial Statement and Budget Report*, HC346, March 2000; Table C18 on page 206 of HM Treasury, *Financial Statement and Budget Report*, HC279, March 2001; Table C10 on page 232 of HM Treasury, *Financial Statement and Budget Report*, HC592, April 2002 (www.hm-treasury.gov.uk/budget/bud_index.cfm).

Summing the payments due until March 2028 (as a share of national income) gives a total of 5.9% of national income, equivalent to £62 billion in today’s prices. But only around 22% of these payments are to finance the initial capital investment.¹³ The rest will pay for current goods and services – for example, the delivery of usable hospital beds rather than a hospital building.

Do the government’s contractual obligations to fund this spending mean that the £62 billion (5.9% of national income) should be regarded as a component of public sector net debt? If so, it would bring the debt level far closer to the ceiling of 40% of national income set by the Chancellor’s sustainable investment rule. It should be noted, though, that £26 billion out of this £62 billion represents payments that are due to be made before March 2008. These are included in the government’s published plans for future current

¹³ Arthur Anderson and Enterprise LSE, *Value for Money Drivers in the Private Finance Initiative*, London, 2000.

spending and therefore score against both future public sector net borrowing and future public sector net debt.

Including the estimated stream of future payments would provide an estimate of the increase in public sector net debt that we might expect to see if the government decided to pay for all of these contracts upfront and continue to receive the services that they provide in the future.¹⁴ But it is far from clear that including them in public sector net debt would be particularly sensible.

For one thing, there are large parts of public spending that the government (and all political parties) are, in practice, no less committed to than payments to PFI contractors. Examples of such spending include the provision of many public services (such as some healthcare) free at the point of use and increases in many welfare benefits (such as the basic state pension) at least in line with inflation. These de facto liabilities are not added to public sector net debt – and if they were, they would add up to a very large proportion of national income. They are paid for conventionally out of future national income when the services they provide are consumed.¹⁵

One could also argue that future payments to PFI providers are different from these other liabilities because they are contractual obligations. But if the government were to decide that it no longer wanted the services that it had bought from these private providers, it should be able to negotiate a substantial discount on the contracted payments because they would no longer have to provide them. The provider would doubtless still demand sufficient payment from the government to cover the cost of the initial capital investment. In any event, the future stream of payments due to PFI providers does not necessarily represent an unavoidable cost to a future government that might not want to consume some packages of services that its predecessors have signed up to.

On balance, including the stream of future payments as public sector net debt on transparency grounds does not seem particularly sensible. It would also provide an incentive for governments not to use the PFI even if this offered demonstrably better value for money than conventional finance.

There is also nothing sacrosanct about the ceiling of 40% of national income placed by the Chancellor on a particular measure of government debt. Economic theory has little to tell us about what an optimal debt-to-GDP ratio is, just that it should not be allowed to increase continuously over time. The Chancellor could just as easily have chosen a different measure of debt, or a different percentage. Indeed, if the Chancellor had chosen a measure of debt that included the future financing of PFI contracts, he may well have chosen a target higher than 40%.

¹⁴ The actual value would depend on the discount rate of the private sector. Using the £62 billion calculated above would assume a discount rate equal to nominal growth in national income of 4.8% (which comprises long-term real growth in national income of 2¼% and inflation of 2½%).

¹⁵ Whether or not current government policy is sustainable in the medium and long term can be examined, under a number of assumptions, using generational accounts. See HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, November 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/assoc_docs/prebud_pbr02_adsustain.cfm).

The Stability and Growth Pact

Should the UK decide to join the Euro, fiscal policy might be further constrained by the Stability and Growth Pact. This requires member countries to set a medium-term budgetary objective of ‘close to balance or surplus’. This implies either higher taxes or lower public spending than required by the golden rule since it prohibits the government from borrowing to invest.

Joining the Euro also formally requires the UK government to comply with the Excessive Deficits Procedure in the Maastricht Treaty. This requires that general government gross debt should be below 60% of national income and that deficits should be below 3% of national income. Should these criteria not be met (either in terms of actual outcomes or in terms of plans), the European Council could choose to apply penalties such as fines.

The danger with a balanced-budget rule is that it could inappropriately prevent spending on beneficial investment projects that are prohibitively expensive for current taxpayers alone to finance, because it would not permit future generations to bear part of the cost.¹⁶ This seems unreasonable, given that individuals often choose to fund long-term purchases by borrowing – for example, paying for a house with a mortgage.

As we discussed earlier, the golden rule does make a distinction between capital and current spending and therefore would allow such investment projects to go ahead. This is not to say that the golden rule is necessarily ideal. For one thing, it is hard to decide whether some categories of spending (e.g. education) should be current or capital. Neither is it clear that the golden rule delivers true intergenerational fairness, because the timing of the flow of services financed by borrowing may not coincide with the timing of payments on the debt.

It is possible that the balanced-budget rule – or at least its interpretation – might be relaxed by the time the UK joined the Euro. EU President Romano Prodi has stated that ‘the stability pact is stupid, like all decisions that are rigid’.¹⁷ Also, in a November 2002 Communication to the European Council and Parliament, the European Commission argued that the balanced-budget rule should be interpreted using a cyclically adjusted measure of the budget position and that countries with debt ‘well below the 60% reference level’ would be allowed small deviations from the balanced-budget rule. In parallel, the Commission argued that the balanced-budget rule ‘could be required to cater for the inter-temporal budgetary impact of large structural reforms (such as productive investment or tax reforms) that raise employment or growth potential’.¹⁸ While these changes would not make the Stability and Growth

¹⁶ An argument made in favour of a balanced-budget rule is that a golden rule would simply provide an incentive for countries to redefine how they classify investment spending and, in particular, how depreciation is measured. This is discussed in, for example, M. Buti, S. Eijffinger and D. Franco, ‘Revisiting the Stability and Growth Pact: grand design or internal adjustment?’, Centre for Economic Policy Research, Discussion Paper no. 3692, 2002 (www.cepr.org/pubs/new-dps/dplist.asp?dpno=3692).

¹⁷ Interview to the *Le Monde* newspaper, 17 October 2002.

¹⁸ Commission of the European Communities, *Communication from the Commission to the Council and the European Parliament*, COM (2002) 668 final, Brussels, 27 November 2002.

Pact criteria identical to the UK fiscal rules, they would certainly bring them closer – not least by potentially allowing higher deficits to finance investment spending, provided debt is significantly lower than the 60% mark.

Table 2.3 shows how in 2001 the UK compared with other EU countries in terms of both government borrowing and debt. In that year at least, the UK had a relatively strong public balance (net borrowing or lending), with a surplus of 0.8% of national income compared with a weighted average of –0.8% across the entire EU and –1.5% across the Eurozone. Equally, when the cyclically adjusted measure of the public balance is considered, the UK's surplus of 0.6% of national income compares favourably with both the EU weighted average of –1.0% and the –1.5% average in the Eurozone countries. The UK also had a relatively low level of general government gross debt (39.1% of national income compared with a weighted EU average of 63.1% and a weighted Eurozone average of 69.2%).

Table 2.3. Public finances across the EU in 2001, percentage of national income

	Public balance	Cyclically adjusted public balance	Debt
Portugal	-4.1	-4.6	55.5
Germany	-2.8	-2.4	59.5
Italy	-2.2	-2.1	109.8
France	-1.4	-1.7	57.3
Greece	-1.2	-1.7	107.0
Spain	-0.1	-0.2	57.1
Netherlands	0.1	-0.2	52.8
Austria	0.2	0.1	63.2
Belgium	0.4	0.3	107.6
UK	0.8	0.6	39.1
Ireland	1.5	-0.1	36.4
Denmark	3.1	2.9	44.7
Sweden	4.8	4.7	56.6
Finland	4.9	5.1 ^a	43.4
Luxembourg	6.1	n/a	5.6
Unweighted EU average	0.7	0.1 ^b	59.7
Weighted EU average	-0.8	-1.0	63.1
Unweighted Eurozone	0.1	-0.7 ^b	62.9
Weighted Eurozone	-1.5	-1.5	69.2

^a Given as a proportion of mainland potential GDP. The figure excludes revenues from oil production.

^b These unweighted averages exclude Luxembourg.

Note: Public balance refers to net borrowing or lending of consolidated general government sector. Debt refers to general government consolidated gross debt.

Source: EUROSTAT website (<http://europa.eu.int/comm/eurostat/>) and OECD, *Economic Outlook*, no. 72, December 2002 (www.oecd.org/EN/document/0,,EN-document-0-nodirectorate-no-2-21578-0,00.html).

Even if the interpretation of the balanced-budget rule were to be relaxed – for example, by allowing countries with a relatively low level of debt to borrow more – the UK might still be constrained by the Excessive Deficits Procedure. UK public sector net investment is forecast to grow to 2.0% of national

income in 2005–06¹⁹ (which is the last year of the current Spending Review period). Even with a balance on the cyclically adjusted current budget, the limit on borrowing of 3% of national income would be being breached if economic growth in 2004–05 were more than 1¼ percentage points lower than expected and there were no bounce-back in the following year.²⁰

2.2 Planning and forecasting revenues

Most tax revenues tend to follow the ups and downs of the economic cycle, because they are levied on elements of incomes and spending that move roughly in line with activity in the economy as a whole. For example, when the economy is strong, more people will be in paid employment and paying income tax and National Insurance. As earnings generally rise in excess of inflation, over time people will also tend to be pulled into higher income tax brackets. The number of higher-rate taxpayers has increased from 1.7 million in 1990–91 to an estimated 3.1 million in 2002–03.²¹ This process of ‘fiscal drag’ results from the progressive structure of the tax system and means that income tax receipts tend to rise as a proportion of national income.

As we discussed in Section 2.1, it is possible to adjust revenue (and spending) figures for the impact of the economic cycle and thereby better gauge the underlying strength of the public finances. But this is never easy, and it may be particularly difficult now. One important reason is that some tax revenues are affected significantly by movements in asset markets, such as the housing market and the stock market. These tend to be prone to longer, more pronounced and less predictable cycles than economic activity as a whole. This is evident from the boom and recent decline in the stock market, with fears mounting in recent months that the housing market is due for a similar setback after a lengthy period of strong growth.

A recent study published by the European Central Bank concluded that asset price movements are an important determinant of budget balances in many countries – over and above the impact of the cycle in national income.²² But the study found that this effect was particularly marked in the UK. There is a danger that the Treasury has underestimated the impact of asset price movements on the public finances. This may mean that revenues bounce back

¹⁹ Table B6 on page 191 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

²⁰ The Treasury estimates that a 1 percentage point reduction in growth increases borrowing by 0.5% of national income in the first year and by a further 0.3% of national income the following year. Therefore a 1¼ percentage point reduction in growth would increase borrowing by 1% of national income in the following year. This, added to the 2% planned investment spending, would lead to public sector borrowing of 3% of national income. Source: Paragraph B17 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

²¹ Inland Revenue, *Inland Revenue Statistics* (www.inlandrevenue.gov.uk/stats/income_tax/it_t01_1.htm).

²² F. Eschenbach and L. Schuknecht, ‘Asset prices and fiscal balances’, European Central Bank, Working Paper no. 141, 2002 (www.ecb.int/pub/wp/ecbwp141.pdf).

less sharply than the Chancellor expects as the economy moves back to trend output. This would make it harder to be confident of meeting the golden rule. The stock market has a direct impact on revenues via stamp duty, which is levied on share transactions (and also property transactions). We discuss both types of stamp duty in greater detail below. The stock market also has an indirect effect by influencing the fortunes of financial companies, which pay corporation tax and whose employees contribute to income tax and National Insurance receipts. In the November 2002 PBR, the government revised down its revenue forecasts by £5 billion specifically because of the plight of financial sector companies. This comes on top of a £3½ billion downward revision for other stock market effects.

Although income tax revenues generally track movements in the economy, in recent years they have come in more strongly than anticipated by the Treasury. For example, the March 2001 Budget revised upwards its forecast of income tax revenues in 2001–02 by £6 billion compared with the forecast made a year earlier.²³ If a significant proportion of the unexpected increases in income tax receipts was due to the strength of the stock market, then there has to be some concern about the path that income tax receipts will take in the future.

Corporation tax (CT) revenues have become increasingly reliant on the financial sector too in recent years, with the share coming from that quarter doubling from 18% to 36% between 1990 and 2000 alone.²⁴ This helps explain the recent weakness of CT revenues (which we discuss in greater detail below) and suggests that the future path of CT revenues will depend much more than in the past on the performance of the financial sector. Unless one is willing to assume that stock markets and financial companies' profits soon return to the unusual levels of performance seen in the late 1990s, it seems doubtful that corporation tax revenues will rebound as quickly as the Chancellor expects.

Even if the stock market does recover strongly, boosting the financial sector, there remain risks to the UK public finances from the uncertain prospects for house prices. Even a relatively small fall in house prices, if associated with a sharp decrease in the volume of sales, could have a big impact on stamp duty revenues and a smaller impact on inheritance tax and capital gains tax. Moreover, any downturn in the housing market could lead to a decline in consumer confidence and a corresponding fall in revenues from VAT.

A third asset price effect could operate through the currency market. Some analysts expect a sharp drop in sterling, accompanied by a rebalancing in the economy away from consumer spending and towards exports. As the government receives more tax revenue from each pound of the former than of the latter, this too could have a sustained depressing effect on tax revenues.

We now turn to stamp duty and corporation tax in more detail.

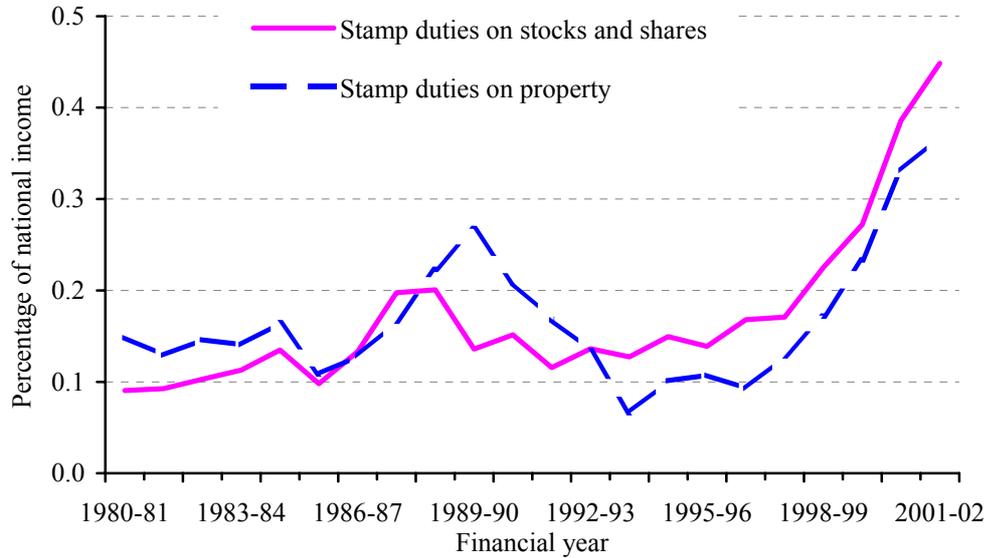
²³ See paragraph C37 of HM Treasury, *Financial Statement and Budget Report*, HC279, March 2001.

²⁴ Tables 11.4 and 11.5 of Inland Revenue, *Inland Revenue Statistics*, various years.

Stamp duty

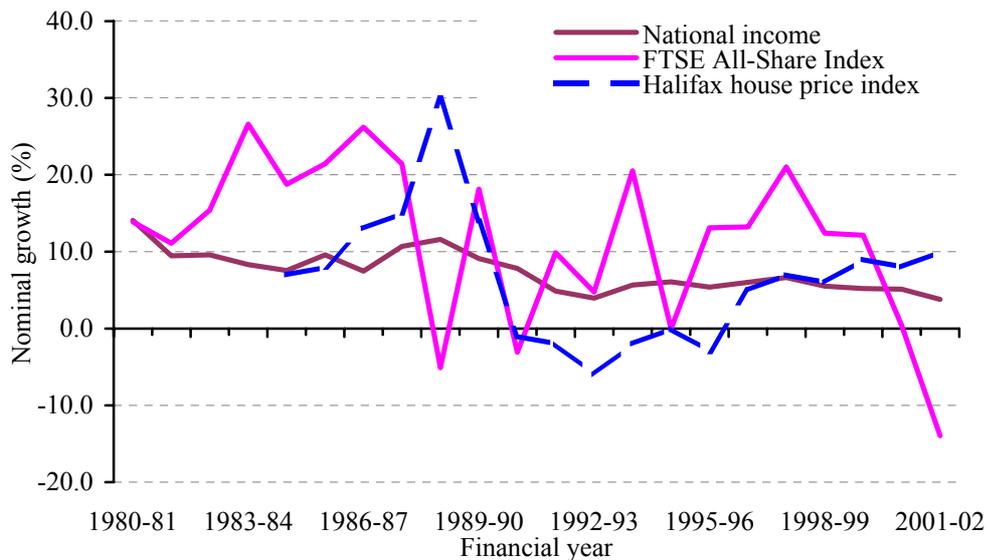
We can see the impact of asset markets on the UK public finances in the path of revenues from stamp duty on property and share transactions. The tax bases for these duties are directly related to the level of prices and volume of transactions in the housing market and stock market respectively.

Figure 2.6. Revenues from stamp duty on shares and property



Source: *Inland Revenue Statistics*, various years.

Figure 2.7. Nominal growth in national income, the FTSE All-Share Index and house prices



Source: GDP – ONS, www.statistics.gov.uk; Halifax house price index – HBOSplc, www.hbosplc.com/view/housepriceindex/housepriceindex.asp; FTSE – Thomson Financial Datastream, www.datastream.com.

Revenues from these taxes between 1980–81 and 2001–02 are shown as a share of national income in Figure 2.6. Annual growth in national income, house prices and the FTSE All-Share Index are shown in Figure 2.7. As the increases in national income, the FTSE All-Share and house prices are shown in nominal terms, they will be higher at times of high inflation, other things being equal.

The figures confirm that stamp duty revenues do not have a consistent relationship with economic growth. Instead, stamp duty on property tracks movements in house prices, although stamp duty on stocks and shares has, at best, a weak lagged correlation with share prices. In the case of stocks and shares, the volume of transactions plays an important role, and a high volume need not be linked to a bull market. It should be noted that stamp duty on shares was cut from 2% to 0.5% during the mid-1980s, while the stamp duty rate on property has been increased four times since Labour came into power in May 1997.²⁵ But these changes do not alter the underlying picture.

For most of the years from 1980–81 to the late 1990s, stamp duty revenues from stocks and shares were broadly constant as a proportion of national income – despite the cuts in the rate of stamp duty on shares in the mid-1980s. The peak observed in 1988–89 did coincide with strong economic growth, both in the current and the previous financial year. But the dramatic revenue increases observed since 1995–96 come at a time of unspectacular economic growth. These increases in stamp duty revenues do, then, appear to be explained by a rising stock market and also an increase in the number of shares and share turnover, rather than by economic growth.²⁶

Revenues from stamp duty on property transactions also diverge from the path of the wider economy. From 1970–71 to the mid-1980s, they rose slowly. From 1985–86 to 1995–96, they followed the economy with a lag of a year or two. Since then, the pattern has been broadly in line with revenues from stamp duty on stocks and shares, rising steadily despite average economic performance. Despite the obvious contribution of increases in the rate of stamp duty on property since May 1997, an important factor has been the rise in the housing market, which has increased in value by over 75%. Taking out the effect of the increases in rates would still leave revenues from property by 2001–02 being more than double the revenue in 1996–97.

Corporation tax

Corporation tax accounts for a relatively modest 12% of total tax revenues.²⁷ But it plays an important role in explaining movements in the public finances

²⁵ See Chapter 9 for more details on changes to stamp duty on property in recent years.

²⁶ For more details and an assessment of the economic impact of stamp duty on shares, see M. Hawkins and J. McCrae, *Stamp Duty on Share Transactions: Is There a Case for Change?*, Commentary no. 89, IFS, London, 2002 (www.ifs.org.uk/corptax/comm89.pdf).

²⁷ This is the average over calendar years 1987 to 2001. Data source: National Statistics, *Financial Statistics*, The Stationery Office, London

because it is one of the most volatile sources of tax revenue. More than half the cut in revenue forecasts made in the 2002 PBR came in corporation tax.²⁸

Whether or not such a fall is worrying will depend on whether corporation tax revenues can be relied upon to bounce back soon. The government believes they can. In 2001–02, corporation tax raised 2.9% of national income.²⁹ The Treasury expects this to fall to 2.5% for two years and then return to 2.9% in 2004–05. In the following two years, the forecasts predict even higher revenues, of 3.2% and 3.3% of national income respectively. This sounds reassuring, but is it credible? Since Budget 2001, corporation tax forecasts have been cut on three consecutive occasions in the light of disappointing outturns. Each downward revision of the forecast for the near future has been accompanied by an upward revision of the growth rate of revenues for later years. This implies that almost the entire revenue decline is attributed to cyclical or other temporary factors that will soon reverse.

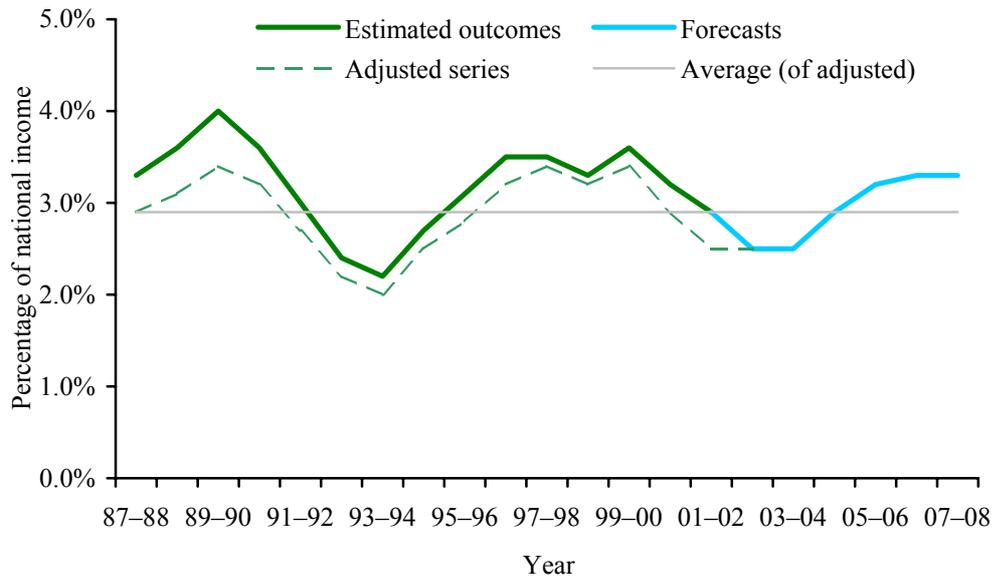
But even if one were to accept that the entire fall in revenues were due to such factors, the long-run forecast of 3.3% would still seem optimistic, as Figure 2.8 illustrates. This figure shows corporation tax revenues as a share of national income over the last 15 years (thick black line) and predictions for the following five years (thick grey line). Over the last 15 years, corporation tax revenues averaged 3.2% of national income. While this seems very close to the forecast, it ignores the fact that tax rates have been cut. Revenues also received a temporary boost in the four years from 1999–2000 to 2002–03 from the introduction of a payment system in quarterly instalments (see Chapter 9). This had the effect of bringing tax payments forward and thus led to companies paying more than one year's tax per year during the transition to the new system.

The dotted line shows an approximation of the revenues that would have been raised with current tax rates and having stripped out the temporary effect of the introduction of quarterly payments. These adjustments shift the graph downwards in each of the last 15 years. The average yield, represented by a thin grey line, drops to only around 2.9% of national income. This casts some doubt on the long-term forecast of 3.3%. Not only is the forecast clearly above the average of what the current system would have raised (despite the fact that the Treasury does not currently forecast output rising above trend after 2005–06), but also it is set so high that the forecast level would only have been reached three times during the last 15 years according to our adjusted series. The predicted level of corporation tax revenues for the long term therefore seems unduly optimistic, especially given the importance of the financial sector we noted earlier.

²⁸ Forecasted tax revenues fell by £6 billion; the cut in forecasted corporation tax revenues contributed £3.7 billion to this figure. Source: Table B9 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

²⁹ This and the following figures exclude corporation tax revenues from the continental shelf and are gross of enhanced and payable tax credits. Source: HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

Figure 2.8. Non-North-Sea corporation tax revenues and forecasts as a share of national income



Notes: The adjusted series shows the tax revenue that the current tax system would have raised in previous years. It takes account of the fact that tax rates have been reduced in two steps from 33% to 30% and that the introduction of a quarterly payments system boosted revenues temporarily between 1999–2000 and 2002–03.

Sources: Inland Revenue, *Inland Revenue Statistics*, London, 2002; HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm); Inland Revenue, 'A Modern System for Corporation Tax Payments', Press Release IR 9, 17 March 1998.

Corporation tax revenues are very volatile and difficult to predict, and frequent revisions are not surprising. It makes sense not to change long-term forecasts every time short-term revenues change. But when revisions always go in the same direction, the long-term forecasts need to be questioned at some point. Looking further ahead, other forces may affect the UK's ability to raise revenue from corporate income taxes. These include more intense tax competition between governments and possible action by the European Court of Justice in response to company complaints or new European Union directives.

2.3 Planning government spending

Since taking office in 1997, the government has substantially reformed the planning and presentation of government spending, including the creation of new aggregates with which to measure it. Total managed expenditure (TME) is the broadest measure of public sector spending. At 40.2% of national income in 2002–03, it is currently lower than the 41.0% spent in the last year

of the Conservative government (1996–97). But TME is now set to rise to 42.3% by 2007–08.³⁰

TME is divided into annually managed expenditure (AME) and departmental expenditure limits (DELs), with around 45% of TME falling in AME and the remaining 55% in DELs. AME is planned on an annual basis, as its name suggests, and includes spending on items that are deemed more difficult to plan years in advance, such as social security and debt interest payments. DELs include spending plans for most government departments and, since 1998, are set up to three years in advance in biennial Spending Reviews. The third Spending Review, in July 2002, revised the plans set out in July 2000 for spending in 2003–04, and set out new spending limits for the years 2004–05 and 2005–06. The plans for 2005–06 are expected to be revised in the next Spending Review, in July 2004, which will also unveil plans for 2006–07 and 2007–08. Unusually, we do have some information about spending in those two years, as the April 2002 Budget set out the NHS spending plans for all years until 2007–08. These allow for an average annual real increase in NHS spending of 7.3% by 2007–08 compared with last year.

The point of having Spending Reviews that set DELs up to three years in advance is that it should allow departments to plan their spending with a longer-term perspective. In recent years, the government has added money to DELs between Spending Reviews. But this is unlikely in the forthcoming Budget due to the weakness of receipts, which has already led to upward revisions in the borrowing forecasts, and due to the fact that the last Spending Review was only in July 2002. Instead, we are likely only to see revisions to AME.

Planning departmental expenditure limits

In the early years of the current planning regime, several departments failed to spend their full allocations and overall spending under DELs came in lower than planned. It was argued that this may have been partly due to the introduction of End-Year Flexibility, which gave departments an entitlement to spend any of their unspent allocation for a given year in subsequent years. The idea was to remove the incentive that previously existed for departments to spend all their money at the end of a financial year, even if they could have obtained better value for money by spending it later.

Spending out-turn figures for 2001–02 show that underspending on current items has ceased to be a problem. Figures to date for 2002–03 show that, if anything, current spending is increasing faster than the plans allow.³¹

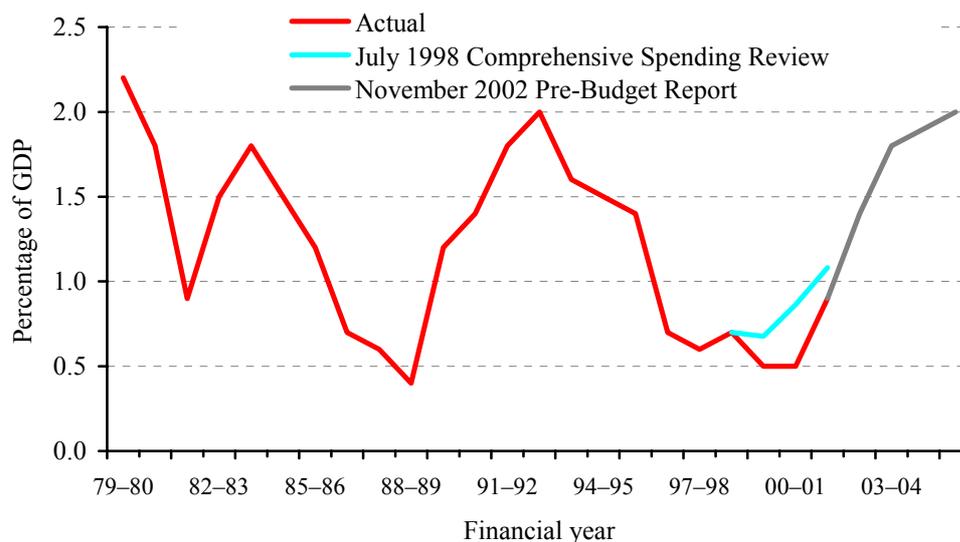
But the delivery of investment spending remains problematic. Figure 2.9 shows investment spending as a percentage of national income from 1979–80 to 2005–06 according to Treasury forecasts. Net investment as a percentage of national income was volatile over most of the 1980s. After reaching just over

³⁰ Table B6 on page 191 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

³¹ For more details, see IFS Public Finances Bulletin, 21 January 2003 (www.ifs.org.uk/press/pub_fin.shtml).

2% of national income in 1992–93, it fell to less than 0.6% by 1997–98. The July 1998 Comprehensive Spending Review (CSR) included plans to increase investment spending steadily over the next three years to nearly 1.1% of national income by 2001–02. This is also shown in Figure 2.9. Despite these plans, investment spending fell in the first year of the plans (1999–2000) to the lowest level since 1988–89. Although investment spending increased in 2000–01 and 2001–02, it was only in 2001–02 that spending was higher than when Labour came into power in 1997. In 2001–02, net investment stood at £8.8 billion – 30% lower than the £13 billion announced in the July 1998 CSR. In the first nine months of 2002–03, we have seen net investment increase by 11.3% over the same months last year. In order to attain the level expected under current plans, the overall increase in investment spending would have to be 53.9% for the whole year. In order to attain this and spend the £14.3 billion outlined in the November 2002 PBR, investment spending for the remaining three months would have to be 97.5% higher than the same period last year.

Figure 2.9. Public sector net investment: out-turns and forecasts as a percentage of national income



Source: Out-turn figures from HM Treasury, *Public Finances Databank, January 2003*, London, 2003 (www.hm-treasury.gov.uk/media/4EC32/jan03web.xls); forecasts from HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm); July 1998 Comprehensive Spending Review figures from HM Treasury, *Pre-Budget Report*, Cm. 4076, London, November 1998, as the plans set out in the actual Comprehensive Spending Review were set using a different accounting system.

Public sector pay

Over the three years from 2002–03 to 2005–06, resource departmental expenditure limits are due to increase by 7.6% a year on average in nominal

terms.³² This represents a 5.1% average annual increase in real terms. It is from within these increases that the government will have to fund any pay increases in the public sector. It is clear from the increases planned in overall spending that there is considerable scope for increasing the amount the government spends on wages in the coming years.

These significant increases for resource DELs, initially unveiled in the July 2002 Spending Review, were presented to enable an improvement in the quality of public services. There are some parts of the public sector where relatively high pay increases may be necessary to improve services by recruiting more high-quality staff or by motivating and retaining existing staff. While large increases in the pay of particular public sector workers will be easily affordable within the existing spending plans, large pay increases across the board will not be. Total remunerations to public sector workers are in the region of £115 billion a year – so each additional 1% increase in pay will use just over £1 billion of resources available to the government.³³ The government should certainly weigh up carefully the benefits it might expect from increases in wages against those it could expect to derive from spending the money differently.

Issues in planning annually managed expenditure

Given the proximity of the Spending Review in July 2002, which set departmental expenditure limits through to March 2006, it is likely that any revisions to public spending announced in the Budget will be changes to annually managed expenditure rather than changes to DELs.

Changes to AME might occur for at least two reasons. First, the Chancellor, as discussed in Chapter 4, might decide that he would like to announce further increases in financial transfers to low-income families with children so that the government can continue to progress towards its child poverty targets. Secondly, the Chancellor might decide that he needs to increase the funds he has available in case of unforeseen contingencies.

This contingency reserve is known as the AME margin, and recent years have seen it used to pay for the costs of the BSE crisis and the foot-and-mouth epidemic. Since the 1998 Comprehensive Spending Review, the Chancellor has tended to ensure that the margin contains £1 billion for the following financial year, £2 billion for two years hence and £3 billion for three years hence. Table 2.4 shows the size of the AME margin in recent years. Each Spending Review (in 1998, 2000 and 2002) and Budget (1999, 2000, 2001 and 2002) has left the AME margin at £1 billion, £2 billion and £3 billion in one,

³² Table B17 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

³³ According to the National Accounts Blue Book of 2000, total wages and employers' social contributions of those in public corporations, central government and local government were £104 billion. Assuming 5% nominal growth a year over the last two years would imply spending in 2002 of around £115 billion.

two and three years' time respectively. As shown in last year's Green Budget, these levels of reserve are low by historical standards.³⁴

At the time of the Pre-Budget Report, the Chancellor has tended to adjust the AME margin to offset changes in the remainder of AME. So, for example, in November 1998 and November 1999, falls in forecast expenditure on AME led to increases in the size of the margin. In the following Budgets, the Chancellor was able to 'reset' the AME margin back to its normal level and use the funds to cut taxes, increase public spending or reduce debt. At the time of the 2002 Budget, £0.5 billion of additional funds were needed to restore the AME margin in 2003–04 to £2 billion.

Table 2.4. The size of the AME margin (£ billion)

	1999– 2000	2000– 01	2001– 02	2002– 03	2003– 04	2004– 05	2005– 06
Comprehensive Spending Review, July 1998	1.0	2.0	3.0				
Pre-Budget Report, November 1998	3.0	4.5	6.0				
Budget, March 1999	1.0	2.0	3.0				
Pre-Budget Report, November 1999	3.5	3.9	6.4				
Budget, March 2000	0.0	1.0	2.0				
Spending Review, July 2000			1.0	2.0	3.0		
Pre-Budget Report, November 2000			2.7	3.6	4.6		
Budget, March 2001			1.0	2.0	3.0		
Pre-Budget Report, November 2001			0.2	1.2	1.5		
Budget, April 2002			0.0	1.0	2.0		
Spending Review, July 2002			0.0	1.3	1.0	2.0	3.0
Pre-Budget Report, November 2002				0.1	1.8	0.5	0.5
Possible Budget 2003 scenario					1.0	2.0	3.0
Addition to spending?					-0.8	+1.5	+2.5

Sources: Various HM Treasury Pre-Budget Report, Budget and Spending Review documentation.

Should the Chancellor wish to restore the AME margin back to its normal levels in the 2003 Budget, then he will need to find an additional £1.5 billion in 2004–05 and an additional £2.5 billion in 2005–06. This will require an increase in borrowing, an increase in taxation or a reduction in spending elsewhere of the same magnitude.

2.4 Conclusions

Under its current plans, the government is set to meet both the golden rule and the sustainable investment rule over the current economic cycle. But the golden rule is forecast to be met with less margin for error than in previous years. The likelihood of deficits on the current budget in the near future underlines the importance of judging whether policy at any given time is consistent with the golden rule looking forward. The sustainable investment rule poses less of a constraint – even if we were to add the future liabilities of the government for capital spending undertaken under the Private Finance

³⁴ See figure 2.7 in A. Dilnot, C. Emmerson and H. Simpson (eds.), *The IFS Green Budget: January 2002*, Commentary no. 87, IFS, London (www.ifs.org.uk/gb2002/chap2.pdf).

Initiative. The fiscal rules are less constraining than the Stability and Growth Pact as it is currently interpreted, although this interpretation may already have changed by the time the UK joins the Euro – if it ever does.

The government expects revenues to recover as the economy picks up. But movements in asset markets complicate the task of assessing the underlying health of tax revenues and the public finances more generally. The Chancellor's forecasts show stamp duty and corporation tax receipts increasing. As a significant part of these revenues is linked to the performance of the stock market and financial companies, it may be risky to rely too much on this rebound. The public finances might well turn out to be less healthy if the stock market does not deliver these missing revenues, while the possibility of a decline in house prices poses a further risk. On top of any concern about revenues, the Chancellor must also decide whether to allocate resources to restore his contingency reserve to the levels he has felt necessary in the past.

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